Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Peace | Analyst: Marion Mann DeJong | Bill Number: SB 2125

Related Bills: See Legislative History | Telephone: 845-6979 | Introduced Date: 02/25/2000

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Water's-Edge/FTB Follow IRS Profit Split Rules for Audit

SUMMARY

This bill would require the use of the profit split method for California purposes if the profit split method was ever elected pursuant to Section 936 of the Internal Revenue Code (IRC) for federal purposes. The bill would provide that the Franchise Tax Board (FTB) would be presumed to have followed federal rules, regulations and procedures for transfer-pricing audits when corporations in a water's-edge group elect to use the profit split method. In addition, it would be presumed that the allocation of combined taxable income under the profit split method clearly reflects the income of the members of the water's-edge group and clearly reflects the income of the electing corporation.

EFFECTIVE DATE

Since this bill is not deemed by Legislative Counsel to be a tax levy, it would become effective on January 1, 2001. The bill does not specify the manner in which it is to be applied. However, under Revenue and Taxation Code (R&TC) Section 18415, as a bill that affects the imposition or calculation of taxes, it would apply to income years beginning on or after January 1, 2001.

LEGISLATIVE HISTORY

AB 1467 (1999) was almost identical to this bill. It was held in Assembly Appropriations Committee and died because it did not pass the house of origin by the constitutional deadline for two-year bills.

AB 1208 (as amended June 29, 1999) contained a similar provision that would have created a rebuttable presumption for possession corporations that elect the profit split method that the allocation of combined taxable income under the profit split method is a proper allocation under transfer-pricing. The profit split method provision was amended out of AB 1208. AB 1208 is in the Senate Appropriations Committee.

SPECIFIC FINDINGS

Under current federal law, corporations organized in the United States (U.S.) are taxed on all of their worldwide income, regardless of source, and are generally allowed a credit for any taxes paid to a foreign country on their foreign source income.

Board Position:			Department Director	Date
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Under current federal law, foreign corporations engaged in an U.S. trade or business are taxed at regular progressive U.S. rates on income effectively connected with the conduct of that business in the U.S. This is known as effectively connected income, or ECI. However, foreign corporations are taxed at a flat 30% rate (or lower rate if provided by treaty) on certain income (usually investment income) from U.S. sources.

Federal law uses the “separate accounting method” to determine the amount of a corporation’s income subject to tax. The separate accounting method determines the income of related corporations on a corporation-by-corporation basis and does not take into consideration the income of related corporations not subject to tax within the taxing jurisdiction.

The separate accounting method is generally premised upon the use of "arm’s-length" pricing in transactions between related parties. Under this principle, the prices or charges on transactions between related parties should be the same as if the transactions occurred between unrelated parties. However, in many situations related corporations may realize an overall tax benefit for the affiliated group by shifting income between affiliates and not charging an “arm’s-length” price.

Internal Revenue Code (IRC) Section 482 was enacted to prevent any arbitrary shifting of income between affiliates. The Internal Revenue Service (IRS) conducts Section 482 audits to determine if the related parties have charged an “arm’s-length” price and, if not, what the “correct” price should be. This is commonly referred to as transfer-pricing.

Under federal law, in determining the Puerto Rico and possession tax credit, a possession corporation[1] may elect to attribute some of the income from intangible property[2] to the U.S. corporation by use of either the cost sharing method or the profit split method. If neither method is elected, virtually all of the income attributable to the intangible property is considered U.S. source income. Thus, a possession corporation is treated as a contract manufacturer not owning any intangible property, even if the intangible property was purchased from unrelated parties or developed by the possession corporation itself.

The Puerto Rico and possession tax credit is terminated for tax years beginning after December 31, 1995. However, special phase-out rules apply in the case of existing credit claimants. Existing credit claimants may continue to claim the credit throughout the last tax year beginning before January 1, 2006. For tax years beginning in 2006 and thereafter, the credit is scheduled to expire.

If the cost sharing method is elected for **federal purposes**, the possession corporation is required to pay its affiliates for its share of product research and development costs incurred by the affiliates during the year. The cost share payment cannot be less than the cost share payment that would be required under IRC Section 482.

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[1] Possession corporations are U.S. incorporated entities located in U.S. possessions, most notably Puerto Rico, which have elected the benefits of Internal Revenue Code Section 936.

[2] Intangible property includes patents, inventions, copyrights, trade names and trademarks.

If the profit split method is elected for **federal purposes**, the taxpayer is permitted to arbitrarily attribute 50% of the manufacturing profits (for the product lines covered by the profit spit method) to the possession corporation. If the federal profit split amount reportable by the possession corporation is less than the amount of net income reported by the possession corporation on its books, the possession corporation will usually remit a payment to the U.S. shareholder.

If the reverse occurs, the U.S. parent corporation remits a payment to the possession corporation. Procedurally, the IRS does not conduct Section 482 audits of corporations electing the profit split method in determining the Puerto Rico and possession tax credit and treats that method as properly reflecting the income of the electing corporation.

Under current California law, California source income for corporations that operate both within and without the state is determined using the unitary method of taxation. Under the worldwide unitary method, the income of related affiliates that are members of a unitary business is combined to determine the total income of the unitary group. A share of that income is then apportioned to California on the basis of relative levels of business activity in the state, as measured by property, payroll, and sales. The fundamental difference between the worldwide unitary method and the federal separate accounting method discussed above is that the prices or charges on transactions between related parties are simply disregarded under the unitary method, as opposed to adjusted under separate accounting rules.

As an alternative to the worldwide unitary method, **California law** allows corporations to elect to determine their income on a "water's-edge" basis. Water's-edge electors generally can exclude unitary foreign affiliates from the combined report used to determine income derived from or attributable to California sources. Therefore, in a water's-edge combined report, the allocation of income between affiliated corporations, some of which are members of the water's-edge group and some of which are not, is relevant to the correct determination of income from California sources.

Generally possession corporations are excluded from the water's-edge combined report group, unless:

- the possession corporation's average United States factor is equal to 20% or more; or
- the possession corporation earns U.S. source income which is effectively connected with a U.S. trade or business, and if the possession corporation is considered a taxpayer for California purposes.

California law requires the department to conduct transfer-pricing audits (Section 482 audits) to ensure that taxpayers include the correct amount of income in the water's-edge combined report. The department is not required to perform an audit if the IRS is examining the taxpayer for the same year or years on the same issues. If the IRS does conduct a detailed Section 482 audit, **California law** specifies that it shall be presumed correct and that the results of the federal audit apply for state tax purposes. This presumption can be overcome if either the FTB or the taxpayer demonstrates that:

- An adjustment or the failure to make an adjustment was erroneous.
- The results of such an adjustment would produce a minimal tax change for federal purposes because of correlative or offsetting adjustments or for other reasons.
- Substantially the same federal tax result was obtained under other IRC sections.

If the IRS does not conduct a Section 482 audit of any particular taxpayer, **California law** specifies that no inference shall be drawn for state purposes from this failure.

California law does not conform to the IRC Section 936 elections relating to the profit sharing or profit split methods used in computing the federal Puerto Rico and possession tax credit. For **California purposes**, IRC Section 482 governs the relationship between a possession corporation and the U.S. affiliates.

This bill would provide that the FTB would be presumed to have followed rules, regulations and procedures of the Internal Revenue Service in conducting Section 482 audits when two or more corporations elect to use the profit split method (under IRC Section 936). In addition, it would be presumed that the allocation of combined taxable income under the profit split method clearly reflects the income of the taxpayer or taxpayers in the water's-edge group and clearly reflects the income of the electing corporation.

This bill would specify that if taxpayers at any time elected the profit split method for federal purposes, the profit split method **must** be used for state purposes. If however, taxpayers do not elect to use the profit split method for federal purposes, the profit split method could not be used for state purposes. Thus, **this bill** would essentially require the use of the profit split method for California purposes if the profit split method was ever elected for federal purposes.

<u>Policy Considerations</u>

This bill would raise the following policy considerations.

- This bill, in subparagraph (B) of paragraph (4) of subdivision (b), specifies that if the taxpayer at any time elected to use the profit split method for federal purposes, then the profit split method shall apply for California purposes. Thus, the profit split method would be required for California purposes even if the taxpayer later elects out of the profit split method for federal purposes. In addition, the profit split method would be used for California purposes even after the federal provisions expire in 2006.

- Section 482 (transfer-pricing) audits are very resource-intensive and taxpayer intrusive. For this reason, California is not required to conduct a Section 482 audit if the IRS has conducted such an audit. Presuming that the profit split method elected under federal law (IRC Section 936) provides the correct value under Section 482, this bill would reduce the number of Section 482 audits the department is required to conduct.

On the other hand, the profit split method may not accurately reflect California income. Further, the profit split method was a policy implemented by the federal government to encourage economic growth in Puerto Rico and other U.S. Possessions. California may not have the same policy reasons for encouraging economic growth in the U.S. Possessions.

Implementation Consideration

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- Since this bill would affect the imposition or computation of taxes, under the provisions of R&TC Code Section 18415, it would apply to income years beginning on or after January 1 of the year in which the act takes effect, which would be January 1, 2001. According to the author's staff, the author intends the bill to apply to audits in progress as of the effective date and thus apply to all open years. The bill does not reflect the author's intent and should be amended to clarify that it would apply to all open years.

- The bill is internally inconsistent. Subparagraph (A) of paragraph (4) of subdivision (b) provides a presumption that the profit split method is correct. This presumption could be rebutted pursuant to the Evidence Code (Section 600 – 647). However, subparagraph (B) provides that if the taxpayer at any time had a federal election then the profit split method shall apply for California purposes, thus providing a conclusive presumption that the profit split method is correct.

Technical Consideration

Amendment 1 would correct an incorrect code section reference.

FISCAL IMPACT

Departmental Costs

If the implementation considerations were resolved, this bill would not significantly impact the department's costs. To the extent that this bill simplifies or reduces transfer-pricing audits and reduces disputes between taxpayers and the department, cost savings for the department's audit and legal staff may result. The extent of these possible savings cannot be quantified.

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses. Estimates were derived assuming a conclusive presumption.

Estimated Revenue Impact of SB 2125 As Introduced 2/25/00 [$ In Millions]		
2000-01	2001-02	2002-03
-$21	-$23	-$27

Estimates assume the bill would be effective January 1, 2001, and that the bill would be amended to reflect the author's intent that the bill apply to all years for which the statute of limitations is open.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The tax differential between following Section 482 transfer-pricing rules and Section 936 profit splitting rules would determine the revenue impact of this bill. Based on an analysis of tax returns of corporations under audit for transfer-pricing issues, tax differentials were approximated and grown 5% per year to the 2000 level. Due to the sunset of IRC Section 936 for income years beginning after December 31, 2005, the level of revenue losses would begin to decline starting in later fiscal years. Because an expired federal election would still be binding for state purposes, revenue losses would continue to exist as long as corporations that made the federal election continue their business activities in Puerto Rico. Estimated losses reflect the projected cash flow impact of reduced taxes plus any applicable interest for the initial three fiscal years beginning in 2000-01.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 2125
As Introduced February 25, 2000

AMENDMENT 1

On page 4, line 13, strikeout "25051.5" and insert:

23051.5